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FY 1991 OUTLOOK FOR THE JAPANESE ECONOMY

Summary

The past year has imposed a number of obstacles to the continued growth of the Japanese economy. Higher interest rates at home and the threat of recession abroad head the list. While the economy appeared to slump in the last part of calendar 1990, only the coming months will reveal whether the apparent slowdown was a response to concerns posed by the Persian Gulf crisis, namely the price of oil and the likelihood of sustained international conflict.

With their economies interrelated in many ways, the United States ignores the state of the Japanese economy at its own peril. Since fiscal 1986 the Japanese economy has grown rapidly, pulling in more imports. In spite of this good macroeconomic performance, trade frictions have risen. Should the Japanese economy falter, relations could worsen further. Partly for this reason, the next 12 months promise to be an interesting, if not necessarily enjoyable, time for policymakers in Washington and Tokyo. The best guess is that Japan's economy will continue to grow, albeit at a somewhat slower pace than in FY 1990.

Japan's Economy in FY 1990

From all appearances the fiscal year that began April 1, 1990 had all the makings of a disaster. The stock market began a free fall in January 1990 that continued into the spring of last year. Many Japanese analysts -- in some contrast to their American counterparts -- argued that the market soon would recover. They were to be proven wrong fairly quickly. Iraq's August invasion

of Kuwait sent the market into a deeper downward spiral and pushed up oil prices, one of the traditional banes of the Japanese economy. Moreover, rising interest rates over the spring and the summer aggravated investors' concerns. The higher rates also threatened to choke off plant and equipment spending, one of the main engines of Japanese economic growth in recent years.

In addition, the economy was buffeted by disquieting foreign economic forces. By all accounts the United States, Japan's largest foreign market, entered a recession in late 1990. Coupled with slower growth elsewhere overseas, the U.S. economic downturn threatened Japan's exports as well as the profits of companies that count on the American market for a significant part of their sales.

As FY 1990 draws to a close some of the negative indicators have reversed course. Oil prices, for example, have dropped to their preinvasion level. Some American experts see signs of life in the U.S. economy. The Japanese stock market, although still far below the peak achieved on the last trading day of 1989, by mid-March had regained more than two-thirds of its lost ground. While short-term interest rates continued to edge upward, long-term rates began falling in September and, by the end of February, were lower than a year earlier.

Assuming that long- and short-term interest rates do not turn sharply upward and that the other factors do not similarly reverse themselves, the relevant question is whether the threats to the economy suggested by these indicators have played themselves out. Perhaps they may prove to be less dangerous than many experts believed or, alternatively, they may remain potentially menacing until defused.

Stock prices probably are in the former category. A falling equities market, by itself, does not pull the economy down, although it may hurt interest-sensitive parts of the economy to the extent that sagging stock prices are tied to higher interest rates. For example, if publicly traded firms have trouble selling new shares, they may have to pay more for funds; that could lead to a reduction in plant and equipment spending, which boosts both aggregate demand and aggregate supply in the Japanese economy. But issuing stock is not the only way companies can raise money; they can borrow, use retained earnings or other sources of cash flow or float bonds. The rate of return on these funds may or may not move in tandem with the yields on stocks. In short, most observers believe that the ups and downs of the stock market have a limited effect on the real economy.

Oil prices, another source of concern to analysts, now appear very unlikely to harm the Japanese economy. Many Japanese experts believe that, even during the 1973-74 and the 1979 oil shocks, high oil prices and shortages per se did little damage to the economy. (For details of this argument, see JEI Report No. 33A, August 24, 1990.) In the aftermath of Iraq's invasion of Kuwait prices did not rise as much -- or stay high for as long -- as during the two oil shocks of the 1970s.

Interest rates -- which still are high by historical standards -- remain a question mark. Some American and Japanese analysts argue that large Japanese companies are virtually immune to higher interest rates because they can tap internal sources of funds for capital spending, but this view is incorrect. Toyota Motor Corp. sometimes is referred to as the "Toyota Bank" because it appears to be flush with cash, but when Toyota's vast subsidiary network is included, Toyota is a net borrower. Even if it were not, higher interest rates on bonds and other fixed-income securities alert investors to seek higher returns on all their investments, including equities. Hence, to satisfy stockholders even a cash-rich firm may well have to earn higher rates of return on its investment projects in the face of steeper interest rates.

These factors imply a decrease in the number of projects able to achieve sufficiently profitable returns. Hence, higher interest rates are likely to lead to reduced plant and equipment spending, even by firms with abundant cash. The role of Japanese households as net savers provides a partial counterbalance to the negative impact of higher interest rates on business investment. As interest rates rise, real incomes increase from the higher interest earned, other factors equal. As a result, consumer spending tends to rise. Even for households, however, interest-sensitive spending, such as home purchases, generally falls in the face of high interest rates.

On balance, higher interest rates will decrease aggregate Japanese demand, slowing the pace of economic activity. Rates would not necessarily have to go higher than the level they reached last summer, for example, to have an effect on the economy; the die already may have been cast. Plant and equipment spending plans, for example, are made months before investments are undertaken; actual spending, in turn, is reflected in official statistics with a one- to three-month lag. In short, weak business investment in the coming fiscal year may result from the level of interest rates in FY 1990, which, by some measures, were at their highest point in more than five years.

Government's FY 1990 Outlook in Review

In the closing days of 1989 the government prepared its outlook for FY 1990. The gross national product was expected to grow 4 percent after adjustment for price increases. If realized, this would have represented a modest slowdown from the 4.6 percent expansion the government then expected for FY 1989. (Actual real GNP growth in FY 1989 was 4.8 percent.) The government projected that plant and equipment spending in real terms would slow significantly to 7.3 percent, while consumer spending was predicted to pick up, rising 4.6 percent. Net exports adjusted for inflation were expected to be a drag on the economy again, as they had been in FY 1988 and would prove to be in FY 1989.

Private forecasters, who announced their figures at about the same time as the government, made similar, if somewhat more bullish, estimates. On average they expected real FY 1990 growth to equal 4.4 percent. At 9.3 percent, the forecast for business investment was higher than that made by the government, but the 4.5 percent advance estimated for consumer spending was slightly below the government outlook. Business analysts generally agreed that the foreign sector would pull down the overall growth rate.

The results now expected for FY 1990 suggest that the consensus private forecast was more accurate than the government outlook, although both projections are proving to be too pessimistic. Furthermore, the structure of growth

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appears more closely to match the average business prediction. Private forecasters on average also had a better record concerning FY 1989's GNP expansion and the components of growth (see JEI Report No. 8A, February 23, 1990).

From among the 39 private forecasters surveyed last year, a clear winner has emerged. Assuming the government's revised FY 1990 outlook of 5.2 percent real growth is correct, Sumitomo Trust & Banking Co., Ltd. will be right on the money with its prediction made 14 months ago. Only it expected such rapid growth. The bank's pessimistic outlook concerning inflation was almost as far from the mainstream and just as accurate; it projected that consumer prices would rise 2.9 percent. As such, it was closer to the now expected rate of 3.1 percent than all but one other forecaster, Kansai Economic Research Center, which had penciled in a 3 percent rate. All the other organizations surveyed underestimated inflation.

Sumitomo Trust's exchange rate forecast also was notable since it projected the weakest yen of all 39 forecasters at Y145=\$1.00. If, as now appears likely, the yen averages Y141 to the dollar for FY 1990, the bank also will be the only forecaster to be more pessimistic than the actual result; moreover, it will be closer to the April 1990-March average than the consensus figure of Y135.5=\$1.00.

In short, the Sumitomo Trust argument a year ago suggested that the economy would grow faster and, thereby, experience greater inflationary problems and downward pressure on the exchange rate than other analysts, whether government or private, had anticipated. The private consensus, in turn, mimicked Sumitomo Trust's direction, albeit less dramatically, in comparison with the government outlook. In all these respects, the Sumitomo Trust forecast apparently has come out on top.

Outlook for FY 1991

Despite the less-than-pinpoint accuracy of its initial FY 1990 outlook, Tokyo is sticking with the same approach in its projections for FY 1991. In an outlook resembling that of a year ago (see Tables 1-3) real overall economic growth is expected to equal 3.8 percent, led by a 6.8 percent increase in plant and equipment spending. Once again, consumers -- whose spending is projected to increase 4.1 percent -- are given the role of picking up the slack created by increasingly sluggish capital spending. In sum, government economists envision a substantial drop-off from FY 1990's currently expected real GNP growth of 5.2 percent; however, in terms of expectations there is only a slight reduction from the initial FY 1990 forecast of 4 percent growth.

While the government's computers have spit out virtually the same numbers as a year ago, private-sector forecasters are in different territory. For example, they have abandoned their role as optimist vis-a-vis government analysts. For the first time in three years business analysts anticipate lower growth than the government does (see Table 4). For FY 1991 they expect real GNP growth to average 3.6 percent, with consumer spending rising 3.9 percent and capital spending up 6.3 percent.

Some perennial optimists, who have been rewarded with top marks for accuracy in recent years, are not leading the cheering section this time. Last year's champ is an example. Sumitomo Trust, while relatively upbeat, is now no

Table 1: Government's FY 1991 Outlook for Real Gross National Product

	<u>Actual</u>			<u>Estimated</u>	<u>Projected</u>
	<u>FY 1987</u>	<u>FY 1988</u>	<u>FY 1989</u>	<u>FY 1990</u>	<u>FY 1991</u>
Real Gross National Product	4.9%	5.9%	4.8%	5.2%	3.8%
Consumer Spending	4.1	5.5	4.1	4.2	4.1
Residential Construction	26.3	4.8	0.7	8.4	-2.7
Private Capital Spending	8.6	16.6	14.1	11.7	6.8
Government Spending*	3.0	0.9	1.8	2.0	1.9

*Sum of government current expenditures, fixed investment and inventory investment.

Source: Economic Planning Agency

Table 2: Other Indicators

(change from previous year unless otherwise indicated)

	<u>Actual</u>			<u>Estimated</u>	<u>Projected</u>
	<u>FY 1987</u>	<u>FY 1988</u>	<u>FY 1989</u>	<u>FY 1990</u>	<u>FY 1991</u>
Industrial Production	5.9%	8.9%	4.5%	5.5%	4.1%
Wholesale Prices	-2.0	-0.7	3.5	2.0	-0.1
Consumer Prices	0.5	0.8	2.9	3.1	2.4
Unemployment Rate (percent)	2.8	2.4	2.2	2.2	2.2
Yen-Dollar Exchange Rate	Y138.3	Y128.3	Y142.8	Y139.3	Y128.1

Source: Economic Planning Agency

Table 3: Japan's Balance of Payments

	<u>Actual</u>			<u>Estimated</u>	<u>Projected</u>
	<u>FY 1987</u>	<u>FY 1988</u>	<u>FY 1989</u>	<u>FY 1990</u>	<u>FY 1991</u>
<u>Dollars (billions)</u>					
Current Account Surplus	\$84.5	\$77.3	\$53.4	\$32.0	\$30.0
Trade Surplus	94.0	95.3	70.0	57.0	56.0
Exports	233.4	267.4	268.1	285.0	305.0
Imports	139.4	172.1	198.1	228.0	249.0
<u>Yen (trillions)</u>					
Current Account Surplus	Y11.7	Y9.9	Y7.6	Y4.5	Y3.8
Trade Surplus	13.0	12.2	10.0	7.9	7.2

Source: Economic Planning Agency

Table 4: Summary of Private Forecasts for FY 1991

(percent change unless otherwise indicated)

	<u>Real GNP</u>		<u>Real</u>	<u>Real</u>	<u>Consumer</u>	<u>Current</u>	<u>Y/\$</u>	<u>Oil Prices</u>
	<u>FY 1990</u>	<u>FY 1991</u>	<u>Consumer</u>	<u>Capital</u>	<u>Prices</u>	<u>Account</u>	<u>Exchange</u>	<u>(\$/barrel)</u>
			<u>Spending</u>	<u>Spending</u>		<u>Surplus*</u>	<u>Rate</u>	
<u>Banks</u>								
Bank of Yokohama, Ltd.	5.6%	3.9%	4.1%	6.6%	2.7%	\$41.8	¥123.8	\$22.0
Toyo Trust & Banking Co., Ltd.	5.8	3.9	3.8	6.7	2.4	43.8	133.0	23.0
Bank of Tokyo, Ltd.	5.0	3.8	4.1	7.5	2.8	36.2	125.0	24.5
Daiwa Bank, Ltd.	5.1	3.8	4.0	8.1	2.8	39.9	128.0	23.0
Mitsubishi Trust & Banking Corp.	5.1	3.8	3.9	7.2	2.9	36.0	128.0	22.8
Sumitomo Trust & Banking Co., Ltd.	5.2	3.8	4.6	6.3	3.2	28.1	131.8	24.0
Dai-ichi Kangyo Bank, Ltd.	5.6	3.7	3.8	7.8	2.4	32.8	129.0	23.0
Mitsui Taiyo Kobe Bank, Ltd.	4.9	3.7	3.7	7.0	2.8	21.5	123.0	24.0
Mitsui Trust & Banking Co., Ltd.	5.1	3.7	3.8	7.1	2.6	27.8	125.0	27.0
Sumitomo Bank, Ltd.	5.4	3.6	3.8	6.8	2.0	39.7	125.0	21.0
Hokkaido Takushoku Bank, Ltd.	5.1	3.5	3.8	5.9	2.6	34.4	117.8	24.7
Industrial Bank of Japan, Ltd.	5.3	3.5	3.7	6.8	3.1	35.1	133.0	21.5
Mitsubishi Bank, Ltd.	5.3	3.5	3.6	7.0	3.0	30.4	125.0	24.5
Nippon Credit Bank, Ltd.**	4.7	3.5	3.7	6.4	2.1	25.1	137.5	25.5
Yasuda Trust & Banking Co., Ltd.	5.1	3.5	3.8	5.7	2.8	40.0	123.0	20.0
Chuo Trust & Banking Co., Ltd.	5.0	3.4	3.9	6.7	2.6	28.4	129.5	23.2
Fuji Bank, Ltd.	5.1	3.3	3.9	5.8	1.7	16.0	130.0	25.0
Tokai Bank, Ltd.	5.0	3.0	4.0	5.3	2.0	31.0	107.5	25.0
<u>Insurance Companies</u>								
Meiji Mutual Life Insurance Co.	5.1	3.9	3.8	6.8	2.3	30.5	125.0	22.0
Tokio Marine & Fire Insurance Co., Ltd.	5.3	3.9	4.2	6.7	2.6	32.5	129.0	22.0
Asahi Mutual Life Insurance Co.	5.3	3.8	3.8	7.2	2.8	28.6	131.8	24.3
Dai-ichi Mutual Life Insurance Co.	4.8	3.8	3.2	5.3	2.9	27.9	132.5	22.5
Sumitomo Life Insurance Co.	5.3	3.7	3.8	5.8	2.8	39.0	129.0	23.0
<u>Trading Companies</u>								
Mitsubishi Corp.	5.1	3.5	3.7	6.5	2.5	36.0	130.0	23.0
Marubeni Corp.	4.9	3.4	4.3	5.5	2.5	33.0	135.0	25.0
Sumitomo Corp.	5.2	3.4	3.7	5.1	3.0	31.2	125.0	27.0
<u>Research Organizations</u>								
Research Institute of the National Economy	5.3	4.2	4.6	7.8	2.7	43.2	126.5	22.0
Daiwa Institute of Research	5.2	4.0	4.2	5.9	2.5	38.0	125.0	22.2
Cosmo Securities Economic Research Institute	5.4	3.8	3.9	6.5	0.8	42.0	131.5	22.0
Mitsui Research Institute	5.2	3.8	3.9	7.0	2.4	40.0	125.0	20.0
Okasan Economic Research Institute	5.3	3.8	4.4	6.7	3.0	33.5	126.3	23.0
Yamaichi Research Institute	5.3	3.7	3.9	5.4	2.6	36.9	127.0	25.0
Kansai Economic Research Center**	5.0	3.5	3.9	6.3	1.8	44.8	128.3	21.3
Nomura Research Institute	4.9	3.5	3.9	4.8	3.2	40.0	131.0	25.0
Sanyo Research Institute	5.3	3.5	4.1	4.4	2.7	34.4	131.3	19.8
Nikko Research Center	5.3	3.2	3.7	3.9	3.1	37.5	125.0	20.0
Kangyo Kakumaru Research Institute	5.2	3.4	3.5	6.5	2.1	34.9	132.0	23.0
Japan Economic Research Center	5.4	2.9	3.8	5.1	2.3	49.5	128.4	23.3
Mitsubishi Research Institute	5.0	2.9	3.6	4.9	2.3	38.3	127.0	21.7
Average Forecast	5.2	3.6	3.9	6.3	2.6	34.9	127.6	23.0

*In billions of dollars.

**Real data use 1980 as base. Other organizations use 1985 as base.

Source: Toyo Keizai Tokai Geppo

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more so than the government, sharing its expectations of 3.8 percent inflation-adjusted growth. Unlike the government, however, the bank sees inflation accelerating, equaling 3.2 percent for consumer prices. Sumitomo Trust also remains willing to go out on the limb from which it saw last year's outcome so clearly. In evaluating the U.S. economy's prospects only one other company is as pessimistic. Mitsubishi Trust & Banking Corp., alone among the forecasters surveyed, shares Sumitomo Trust's belief that the American economy will show no growth at all in calendar 1991. The dim outlook for the U.S. economy explains a substantial portion of Sumitomo Trust's relative pessimism.

Mild optimism about the yen continues for FY 1991, as the business forecasters envision the currency to appreciate to an average level of Y127.6=\$1.00. Tokai Bank, Ltd., one of Japan's 10 largest banks, leads the optimists, believing that the yen will average only Y107.5 to the dollar. Tokai's forecast implies a 31.2 percent appreciation over FY 1990's expected figure. By contrast, the government assumes for calculation purposes that the yen will average Y128.1=\$1.00, but the figure is not a forecast, Tokyo stresses.

The reduction in the current account surplus during FY 1990 has surprised government and private forecasters alike. A drop to less than \$40 billion is likely in FY 1990, more than \$15 billion lower than the government or the business sector initially anticipated. The official outlook expects progress to continue in FY 1991, with the surplus equaling \$30 billion. By contrast, private forecasters put the FY 1991 surplus at \$34.9 billion, which could end up higher or lower than the still unknown actual result for FY 1990.

On balance, private forecasters are almost uniformly gloomier than the government about the prospects for the economy in the year starting April 1. By their reckoning, both the economy as a whole and its components will grow more slowly than Tokyo expects; inflation will be slightly higher and the current account surplus larger. Not surprisingly, the Japan Economic Research Center, whose prediction of 2.9 percent real growth is the lowest (along with Mitsubishi Research Institute's) of all forecasters, projects a current account surplus of \$49.5 billion, the highest estimate. JERC's figures serve as a warning that substantially lower Japanese growth would be accompanied by smaller imports than otherwise, thereby widening the balance of payments surplus.

Factors Affecting the Forecasts for FY 1991

The government outlook for the year starting April 1 and virtually all the private forecasts for FY 1991 were made public in December 1990. The outcome of the Persian Gulf conflict, of course, was unknown, as was the resultant movement in oil prices between December and March. All the forecasts assumed oil prices above \$20 a barrel in both FY 1990 and FY 1991. As of early March the figures for the current fiscal year appear reasonable; through January 1991 FY 1990 customs-clearance crude oil prices averaged \$23.14 a barrel. With oil prices substantially below that level in recent months and expected to remain weak, however, the FY 1991 estimates may be too high. Nevertheless, prices still are not likely to drop dramatically. Customs-clearance oil prices averaged \$16.67 a barrel in the April-July 1990 period -- i.e., for the part of FY 1990 before the invasion of Kuwait; given that Kuwait and Iraq, which in the past have pumped approximately 7 percent of the world's oil, are unlikely to ship any significant amount to world markets in FY 1991, prices in that low range would be unusual in the coming fiscal year.

Some Japanese analysts have suggested that the economy will get a boost from the lower prices that are now expected. Since many of these same analysts predicted that higher oil prices would hardly make a dent in the economy, this would seem to indicate a desire to have one's cake and eat it too. In a typical forecast Fuji Bank, Ltd. estimated that a \$5 swing in FY 1991 oil prices would create a 0.2 percentage point difference in Japan's economic growth. (For details of other estimates of the effect of hypothetically higher oil prices on the economy, see JEI Report No. 3B, January 25, 1991.) Hence, growth rates may be 0.1 to 0.2 point higher in FY 1991 than the figures shown in Table 4 if current oil prices hold.

Another unanticipated development was the approximately \$9 billion that Tokyo pledged to assist the multilateral forces in the gulf. The Diet gave final approval to the funds and the taxes to finance them in early March (see JEI Report No. 9B, March 8, 1991). The one-year hike in the petroleum tax and the corporate income tax, which is expected to raise ¥690 billion (\$5.1 billion at ¥135=\$1.00), will have at most a small adverse effect on economic growth.

The U.S. economy is another factor. In fiscal 1989 exports to the United States amounted to 3.2 percent of Japan's GNP. Even a severe U.S. recession, however, probably would not reduce that amount significantly; a 5 percent drop in shipments over the levels otherwise possible would appear to be the upper limit of the impact on exports of a serious downturn in the American economy. In such a case, simple arithmetic suggests a negative effect on the Japanese economy of under 0.2 percentage point. This repercussion could be larger if, as is likely, the dollar were to appreciate in response to diminished demand for imported goods and capital in this country. Japanese exporters, too, could be expected to adjust prices. A myriad of other factors also would come into play as a result of the hypothetical drop in U.S. demand, some amplifying the initial adverse effect on the Japanese economy and others reducing it. The conclusion: a serious recession in the United States would make a downturn in Japan (roughly speaking, growth under 3 percent) more likely but would be far from sufficient to ensure such a result.

Looming largest of all factors in the outlook for the economy is plant and equipment spending. Its importance is threefold. As a rapidly growing component of GNP in recent years, it has directly explained a high proportion of overall GNP growth. For example, in the 12 months ending September 30, 1990, the most recent yearlong period for which data are available, real plant and equipment spending accounted for 45.1 percent (2.3 percentage points) of the overall real growth rate of 5.1 percent. Linked to this first idea is that the importance of plant and equipment spending to the overall economy has been growing; between FY 1985 and FY 1989 it rose from 16.3 percent to 18.7 percent of nominal GNP. Third, such investment lays the foundation for future GNP growth, especially if, as surely will happen, Japan's labor force grows increasingly slowly and the contracts over the next 10 years. (For details, see JEI Report No. 46A, December 7, 1990.)

Given such importance, one argument concerning plant and equipment spending deserves serious consideration. As nominal interest rates reached low levels during the late 1980s, Japanese manufacturers may have recognized a temporary window of opportunity. If interest rates remained low, they may have reasoned, inflation eventually would gather force, making new capital spending more expensive and pushing up nominal interest rates. Faced with this emerging

scenario, the Bank of Japan could opt to push up nominal (and real) interest rates to help thwart significant inflation. In short, business leaders may have figured that real interest rates in the 1986-89 period were abnormally and temporarily low. Either way, the implication for firms was clear: invest in plant and equipment and lock in the related interest charges before both prices and interest rates could go up.

The low interest rate era followed by a few years a related development: the reversal, beginning in 1984 and particularly after 1986, in the downward drift of plant and equipment spending as a percentage of GNP that had been characteristic of the 1970s. Between 1970 and 1979 the share of business investment in nominal GNP dropped from 21.1 percent to 14.8 percent; between 1979 and 1983 the figure showed no clear trend. As noted above, in recent years the figure has rebounded, almost returning to its 1970 level. (For details, see JEI Report No. 15A, April 14, 1989.)

The upward movement in interest rates over the last two years or so raises the question as to whether the 1970-79 downward trend in plant and equipment investment as a share of GNP will resume. More important, would capital spending be sharply lower in FY 1991 in response to what might prove to be its temporary inflation in the FY 1986-FY 1990 time frame? If this development is possible, then the relatively bearish government projections of plant and equipment spending in FY 1989 and FY 1990 are relevant. If the forecasters were right about the optimal level of the capital stock but wrong about the timing of the investment needed to bring it to that level, plant and equipment outlays, having been borrowed from future years for spending in FY 1989 and FY 1990, could be sharply lower in FY 1991. Like a bubble that expanded for longer than expected, business investment could collapse with worse consequences than anticipated.

On this score the outlook is not particularly reassuring. Recent surveys of plant and equipment spending show that firms are not planning significant increases in FY 1991. For example, a February 1991 Bank of Japan survey of 690 large firms, the central bank's initial poll of investment plans for FY 1991, showed that these companies plan to raise plant and equipment spending a measly 1.1 percent compared to an anticipated 16.9 percent jump in FY 1990 (see JEI Report No. 10B, March 15, 1991).

The same survey indicated that manufacturing firms plan to reduce fixed investment 1.1 percent from what they spent in the current fiscal year. While firms typically guess low at the time of the initial February survey compared with their responses after the fiscal year begins, this year's results represent the first time since the initial FY 1987 survey that manufacturers said they would cut capital spending. In 1987 and 1983, the only other occasions since 1980 when large firms said they would reduce plant and equipment investment, predictions ended up as fact. (A separate Bank of Japan survey of small- and medium-sized manufacturing firms revealed that they, too, plan to cut plant and equipment spending in FY 1991. However, similar forecasts by these businesses in the four previous years proved incorrect.)

The BOJ survey results and comparable ones from the Japan Development Bank and Nippon Credit Bank, Ltd. need to be viewed with caution. The selected firms are not necessarily bellwethers of the economy's direction; firms can and do change their decisions. Furthermore, the surveys were conducted during

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February when the outcome of the gulf war was not known. However, while these factors may bias the forecasts downward, the figures are in nominal terms, suggesting an offsetting upward bias.

If plant and equipment spending should falter, what will pick up the slack? Based on size alone, the only alternative is consumer spending, which, at almost 60 percent of GNP, is nearly three times as large as business investment. Given this prospect, the next logical question is whether plant and equipment spending and consumer spending typically move together or separately.

Over time the two economic series have tended to move together, although consumer spending shows less year-to-year variation. In addition, as illustrated by the private forecasts summarized in Table 4, for any given time period higher estimates of plant and equipment spending are associated with higher consumer spending. For example, the Research Institute of the National Economy is among the most optimistic concerning both consumer spending, which it expects to rise 4.6 percent in FY 1991, and plant and equipment spending, which it sees as increasing 7.8 percent, well above the consensus forecast in both instances.

In short, plant and equipment spending bears close watching. Some evidence suggests that it could be riding for a fall; if so, it is likely to pull consumer spending below the levels now anticipated. Along with other, lesser factors, such as the state of the U.S. economy, these arguments suggest that a FY 1991 Japanese-style recession, in which unemployment rises and growth slows markedly but does not disappear, cannot be ruled out. However, these adverse developments remain only possibilities; the best guess is that lower-than-expected oil prices will lift growth slightly above the consensus forecast in Table 4.

Japan's FY 1991 Economy in an International Context

Another reason for worrying about private nonresidential investment is its major role in accommodating the ongoing reduction in Japan's current account surplus. Table 5 tells the story. As Japanese companies have gone on a spending spree for new factories and equipment, they have soaked up surplus savings from the household sector. Funds available for investment abroad, other factors equal, have declined. This, in turn, has reduced the supply of Japanese currency on foreign exchange markets, raising its value. The higher yen has lifted imports, lowered exports and led to a smaller current account surplus than otherwise would be the case.

Nomura Research Institute estimates that, if real plant and equipment spending rises the modest 4.8 percent that it forecasts for FY 1991, then the deficiency in corporate savings actually will decline in FY 1990 and FY 1991. Absent increases in the demand for funds elsewhere, more money will be available for investment overseas, suggesting an increased possibility that both the yen's appreciation and the downward trend in the current account will be reversed.

Table 6 shows the same phenomenon in a different way. Huge increases in business investment have been one of the major domestic factors in GNP growth over the FY 1987-FY 1990 period. As noted above, these outlays also have played a role in boosting the value of the yen, and this, in turn, has contributed to

Table 5: Investment-Savings Balance

(in trillions of yen)

	<u>Actual</u>			<u>Estimated</u>	<u>Projected</u>
	<u>FY 1987</u>	<u>FY 1988</u>	<u>FY 1989</u>	<u>FY 1990</u>	<u>FY 1991</u>
Household Sector	Y28.9	Y25.1	Y40.6	Y36.2	Y35.0
Corporate Sector	-11.4	-15.4	-27.8	-26.5	-25.0
Public Sector	-3.6	2.0	1.2	2.0	0.0
Foreign Sector	-11.7	-9.9	-7.6	-7.7	-7.0
Financial Sector	-2.2	-1.8	-6.4	-4.0	-3.0

Notes: The figures for FY 1990 and FY 1991 are Nomura Research Institute estimates and projections.

A negative figure indicates that a sector is a net user of Japanese savings. Therefore, balance of payments surpluses correspond to negative figures in the table.

Source: Bank of Japan and Nomura Research Institute

Table 6: Components of Japan's Real Economic Growth

	<u>Total Rate</u>	<u>Domestic</u>		<u>External Component</u>
		<u>Private</u>	<u>Public</u>	
FY 1984	4.5%	3.4%	0.1%	0.9%
FY 1985	4.8	4.2	-0.3	0.9
FY 1986	2.9	2.9	0.9	-1.0
FY 1987	4.9	5.3	0.5	-0.9
FY 1988	5.9	6.9	0.2	-1.1
FY 1989	4.8	5.2	0.3	-0.6
FY 1990*	5.2	n.a.	n.a.	-0.3
FY 1991**	3.8	n.a.	n.a.	-0.2

*Calculated from the government's growth estimate.

**Calculated from the government outlook.

Source: Economic Planning Agency

net exports being a drag on the overall growth rate. For FY 1991 Table 6 uses the official outlook for investment spending of 6.8 percent instead of the less optimistic consensus private forecast of 6.3 percent. Among private forecasters those with lower estimates of investment spending typically also predict smaller drops in net exports in FY 1991. In short, if investment should be less buoyant than now expected, Japan's current account surplus could be higher than currently anticipated.

For U.S.-Japan relations this conclusion has obvious importance. It suggests that bilateral relations, while currently not particularly healthy, could worsen along with the Japanese economy. Washington could judge a larger

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Japanese current account surplus as contributing to problems that overshadow the presumed benefits of its inevitable counterpart, an increased capital outflow from Japan.

Conclusion

FY 1991 may provide tentative answers to some intriguing questions. Was plant and equipment spending unusually high in response to unusually low interest rates in the FY 1986-FY 1989 period? If business investment should falter, will automatic market mechanisms make other kinds of spending more appealing, thereby picking up the slack? After five straight years in which the external sector pulled down the rate of economic growth, with corresponding decreases in its importance, could a full-fledged recession in the United States and Europe still matter enough to nudge the Japanese economy into a recession as well? Alternatively, has Tokyo invented the world's first perpetual motion machine that is little fazed even by what would appear to be major economic disturbances?

Some late 1990 and early 1991 data suggest that a slowdown may have begun or be imminent. For example, the leading economic indicators had stood below the boom-or-bust midpoint for four straight months through December, the latest month for which data are available. This period corresponds to one where higher oil prices and, possibly, a devastating war appeared to be in the offing. With those dangers safely past, at least for the foreseeable future, will the yellow warning symbols of the winter turn green with the spring? The answer to that question will be known in a few months, but more fundamental questions about the Japanese economy will remain. For Americans, who are more than spectators of the Japanese economic drama, the answers to those questions will provide insight about their own economy as well.

For further information, contact Douglas Ostrom.

The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.

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